



California Public Employees' Retirement System
Office of Governmental Affairs
P.O. Box 942720
Sacramento, CA 94229-2720
TTY: (916) 795-3240
(916) 795-3689 phone • (916) 795-3270 fax
www.calpers.ca.gov

Agenda Item 6b

May 16, 2011

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. **SUBJECT:** AB 17 (Davis) – As Introduced 12/6/2010
Emerging Investment Managers and Brokerage Firms
- II. **PROGRAM:** Legislation
- III. **RECOMMENDATION:** Oppose, unless amended then Support, once amended
- IV. **ANALYSIS:**

Summary

AB 17 requires the CalPERS Board of Administration (Board) to annually report to the Legislature on the ethnicity and gender of external investment managers who manage retirement fund assets and external firms that provide brokerage services, as well as the ethnicity and gender for owners of these firms. It also requires the Board to develop and include in the report plans and strategies to increase the participation of emerging investment managers and emerging brokerage firms, as defined.

Background

CalPERS actively encourages participation by minority and women-owned, and new and emerging investment management firms by integrating the services of specialist external program advisors and diversity investing consultants to enhance our portfolio management and research capabilities, and further external outreach efforts. CalPERS works with these business partners as well as non-profit educational and industry associations to engage in research briefings, host outreach events and participation in emerging manager and diversity conferences nationwide. Resource additions recently include the CalPERS Investment Officer for Diversity who provides yet another point of contact for emerging managers, and a web-based submission process that allows any investment manager to present investment proposals directly to Investment Office staff in the various asset classes.

Diversity & Inclusion in Portfolio Management

As of fiscal year ending June 30, 2010, emerging investment management firms managed \$8.25 billion of CalPERS net asset value, which equates to 11.2

percent of externally managed assets. The CalPERS Board of Administration has adopted several policies and investment programs to diversify its investments portfolio, which in turn, provides opportunities and resources for the investment industry as a whole. Furthermore, CalPERS Investment Office designs innovative investment programs. The Management Development Program (MDP) launched more than ten years ago allocates capital as well as invests directly in small and emerging public equity investment management firms in exchange for an equity stake. In 2007, CalPERS also established a series of emerging manager programs focused on hedge fund and private equity strategies.

CalPERS Diversity and Investment Reporting

Existing law requires CalPERS to annually report to the Legislature on the investment performance of all external investment managers, and the projected and actual fees paid them. In addition, CalPERS voluntarily produces an annual diversity report with key indicators in each of its specialized investment programs and external diversity outreach efforts that details progress toward more diverse representation among the individuals and firms with whom we do business. It includes, among other information, data on assets under management reported by asset class for emerging investment managers, as well as diversity, including gender, ethnicity and disabled veteran status. We gather this data through voluntary surveys of these firms. However, CalPERS cannot compel our external partners to respond to such requests. This report is reviewed with CalPERS Board of Administration, and thereafter distributed to interested members of the Legislature and Administration, and posted on the CalPERS website.

This annual report is not limited to emerging investment managers and does not define emerging managers in gender and ethnic terms. The various CalPERS investment programs define the term “emerging manager” differently for each asset class based on the strategic needs or requirements unique to each – be it the amount of assets under management or the characteristics of the investable pool of external money managers. In order for CalPERS to achieve long-term sustainable returns, each asset class is responsible for managing risk according to its own strategies, allocations, and definitions.

Proposed Changes

Assembly Bill 17, specifically:

- Requires the Board to annually report to the Legislature, comprehensively and aggregately, on:
 1. The ethnicity and gender of the investment managers who participate in managing CalPERS external fund

management contracts, including all asset classes in which the fund has assets allocated.

2. The ethnic and gender composition of the owners of investment firms that manage CalPERS external fund management contracts.
 3. The portfolio value and asset class managed by each firm, and fees paid to each investment manager.
 4. The ethnic and gender composition of investment officers for contracted portfolio management firms.
 5. The ethnicity and gender composition of the brokerage firms who provide brokerage services to the fund's internally and externally managed investment management firms.
 6. The commissions paid to each brokerage firm utilized by the fund for trading equity securities, including the par value traded for fixed income by product.
 7. Identify brokerage firms who provide brokerage services to CalPERS that are at least 51 percent minority owned or women owned, or both.
- Requires the Board to develop and include in its annual report to the Legislature, a detailed and verifiable plan and strategy to increase the participation of emerging investment managers in each asset class and emerging brokerage firms, as defined, that are internally and externally managed by investment managers that manage publicly traded securities.
 - Requires the Board to develop and report on strategic plans to promote existing underlying emerging managers from manager of manager structures to direct mandates.
 - Defines "emerging investment manager" as a person or investment firm that manages an investment portfolio of less than ten billion dollars (\$10,000,000,000) in publicly traded assets; less than two billion dollars (\$2,000,000,000) in a private equity fund of funds and real estate partnerships; less than five hundred million dollars (\$500,000,000) in REITs, hedge funds, and private equity; and less than one billion dollars (\$1,000,000,000) in a hedge fund of funds.

- Defines “emerging brokerage firm” as a brokerage that is at least 51 percent minority or woman owned.
- Specifies that any percentages provided by the Board shall be used as a reporting threshold only, and not as a basis upon which to contract with any given emerging investment manager or emerging brokerage firm
- Requires the Board to testify at Legislative hearings regarding its reports.
- Specifies that its provisions will not require the Board to take action as described, if the Board determines the action would not be consistent with its fiduciary responsibilities as described in Section 17 of Article XVI of the California Constitution.

LEGISLATIVE HISTORY

- 2011 SB 294 (Price) – Would require CalPERS and CalSTRS to provide five year strategic plans to expand the participation of emerging investment managers across all asset classes. It also requires each system to report on their progress annually until January 1, 2018. *CalPERS Position: Pending.*
- 2010 AB 1913 (Davis) – Would have required CalPERS and CalSTRS to report annually to the Legislature on or before January 1, 2012, and until January 1, 2016, information regarding the ethnicity and gender of emerging investment managers who manage retirement fund assets and the ethnicity and gender of the owners of investment management firms with retirement fund management contracts. The bill also would have required each board to develop and report plans and strategies to increase emerging investment manager participation in each fund's actively managed portfolio to ten percent. This bill died in the Senate Rules Committee. *CalPERS Position: Oppose, unless amended then Support, once amended.*
- AB 1919 (Davis) – Would have required the CalPERS Board of Administration (Board) to annually report to the Legislature on the ethnicity and gender of its external investment managers and external firms that provide brokerage services. It also would have required the Board to develop and include in the report plans and strategies to increase the participation of emerging investment managers and emerging brokerage firms, as defined. This bill died in the Senate Rules

Committee. *CalPERS Position: None.*

Issues

1. Arguments in Support

AB 17 declares that: “as the nation’s leader in attracting private equity capital and advancing innovation, California should also be the leader in encouraging equal opportunity in our State pension fund utilization of emerging investment managers and emerging brokerage firms.”

Support: California State NAACP (Sponsor); United Teachers Los Angeles

2. Arguments in Opposition

There is currently no known opposition at this time.

3. CalPERS Diversity and Investment Reporting

While CalPERS voluntarily produces an annual diversity report of key indicators in each of its investment programs that are used to evaluate progress toward a more diverse representation among the individuals and firms with whom we do business, it does not include a multi-year plan, or establish benchmarks to meet in the coming year. Each asset class establishes and monitors annual investment strategies and plans which include emerging manager programs where applicable to help provide a focus for current efforts and heighten CalPERS transparency regarding its investment policies and programs.

4. Definitions of Emerging Investment Manager and Emerging Brokerage Firm Conflicts Are Problematic

AB 17 defines emerging investment managers by the amount of assets under management (AUM) by an individual or firm, while defining emerging brokerage firms in terms of gender and minority status. While “Emerging Investment Manager” is a commonly used terminology within the investment management marketplace and by CalPERS for policy setting and strategic implementation purposes, its meaning varies by asset class. Moreover, among the institutional investor community, it may be defined very differently; some are based on total assets under management, or stage of a firm’s organizational development, or a combination of some or all of these and other factors or characteristics.

Historically, CalPERS has not identified emerging investment management firms in all asset classes using AUM, nor has it attached gender, ethnicity or minority status to its definitions of emerging investment managers and emerging brokerage firms. In addition, establishing such definitions in statute as proposed by AB 17, or even in regulations as proposed by SB 294, may impair the System's ability to set and then clearly communicate investment strategies intended to be pursued over long periods of time, and ignore the Board's plenary authority over the investment decisions of the Public Employees Retirement Fund (PERF) as granted by the Constitution.

In addition, AB 17 does not define the term minority for these purposes, and the gender and ethnicity data that CalPERS would be required to collect from contracted investment management and brokerage firms, which operate in the domestic and international financial markets with investment officers of numerous nationalities and ethnicities, do not readily lend themselves to determinations of minority status.

It may be possible to meaningfully identify minority status if CalPERS only contracted with domestic investment management and brokerage firms operating in domestic financial markets, however, narrowly defining minority participation in these terms risks limiting the Board's plenary investment authority over asset allocation decisions. It also has the potential to cause confusion in the marketplace regarding the Board's fiduciary responsibility and decisions related to initiating, terminating or expanding existing investment management and brokerage contracts.

Therefore the bill should be amended to allow the Board to continue to define the meaning of "emerging investment manager" and "emerging brokerage firm".

5. Challenges to Considering and Promoting
Emerging Investment Firms, and Gender and Ethnic Diversity in Investment
Decisions

Retirement boards in Illinois have been required to adhere to explicit participation goals by their State Legislature, however, that approach appears to be precluded in California by the prohibitions contained in Proposition 209. Similar measures modeled after Illinois have been proposed in Michigan, New York and Texas. In New York, the Comptroller, who is the sole fiduciary for the State retirement system, has agreed to comply with an annual statutory reporting requirement.

Fiduciary duty dictates that public retirement boards such as the CalPERS Board of Administration, discharge their duties related to investment decision making solely in the interest of the system's members and beneficiaries, and for the exclusive purpose of providing benefits. While the additional duty to diversify the investments so as to minimize the risk of loss and to maximize the rate of return creates opportunities for emerging investment firms to compete, they must generate at a minimum equivalent or superior investment performance and cost impact maintain competitiveness.

In order to include the gender and ethnicity of external investment firms and brokerages in its external portfolio management selection criteria, the CalPERS Board, in its fiduciary role, may be compelled to dedicate significant investment and legal resources over several years of performance measurement and analysis in order to determine whether gender and ethnicity had an impact on performance that advantaged or disadvantaged the PERF. These efforts would include:

- monitoring performance by the gender and ethnicity of all external investment managers, as well as investment management firms and brokerages,
- evaluating performance data for firms identified as meeting to those identified as failing the threshold for ownership diversity specified in AB 17 or some other threshold that could be adopted by the Board, and then
- comparing individual and firm performance against existing asset class and investment strategy performance benchmarks, as well as existing emerging manager-specific performance benchmarks.

While the Board could consider action on these grounds, it is currently outside the scope of its investment criteria as outlined in the Total Fund Statement of Investment Policy. Any definitions of emerging investment manager or emerging brokerage firm should only be used to measure progress in achieving the Board's goals to promote diversity and inclusion in the investment office function. The annual strategic plan reporting requirements as outlined in AB 17 should recognize that fiduciary prudence may, in some instances, dictate reducing exposure to this category of investment manager. Therefore, the Board must be allowed to retain its authority to establish definitions of emerging investment manager and emerging brokerage firm consistent with its fiduciary duties.

6. Legislative Policy Standards

The Board's Legislative Policy Standards recommend an oppose position on bills that create unreasonable cost or complexity for the administration of the System. However, consistent with the position the Board took last year on AB 1913, staff recommends an oppose, unless amended position, then support, once amended to align with the Board's ongoing efforts to increase diversity and inclusion among its external investment managers. This would include, recognizing the Board's authority to establish, and periodically adjust, its definitions of "emerging investment manager." Staff recommends the bill be amended to require CalPERS to provide five year strategic plans to expand the participation of emerging investment managers across all asset classes, without reference to gender or minority status, and report annually to the Legislature on its progress until January 1, 2018.

V. STRATEGIC PLAN:

This is not a product of the CalPERS strategic plan, but an ongoing responsibility of the CalPERS Office of Governmental Affairs.

VI. RESULTS/COSTS:

Program Costs

None.

Administrative Costs

The current reporting requirements of the bill would result in substantial annual costs to collect and analyze the data on the ethnicity and gender of every "investment officer", an undefined term, employed by every external investment management firm that participates in externally managing CalPERS assets whether a private or public investment firm or whether based domestically or internationally. Compared to other reports of this size including staff time to review, edit and approve the different components of the report and the magnitude of required diversity surveying encompassing over 700 investment management firms contracted by CalPERS, the estimated cost could be in the range of \$500,000 to \$750,000.

If the author is willing to accept the suggested amendments the cost could be reduced to \$100,000 or less.

DANNY BROWN, Chief
Office of Governmental Affairs

JANINE GUILLOT
Chief Operating Investment Officer

JOSEPH A. DEAR
Chief Investment Officer

PATRICIA K. MACHT
Deputy Executive Officer
External Affairs Branch